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Why Ireland: How Bank Failure Was Their Key To Success

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Abstract

Despite Ireland's status as the first European Union (EU) country to receive a bailout, Ireland appears to be bouncing back extremely well from the ongoing financial crisis in Europe and the EU. Looking at recent Irish economic statistics it begs the question whether the government's complete guarantee of all Irish debts was the best response. Ireland's financial crisis seemed quite similar to America's: for both the root causes are freely lending for real estate and property. The responses however, were very different. While America let Lehman Brothers fail and only provided a partial guarantee to its banks, Ireland provided a complete guarantee to all debt-holders. Yet as of late, Ireland's unemployment rate has fallen below the EU average, the growth rate of the economy in 2015 was a surprising 5.2% and may be the fastest growing economy in the EU at the moment. Using an analysis of the Irish government's response to the crisis this paper investigates why Ireland's complete guarantee, without traditional Emergency Liquidity Assistance (ELA) funds, became the best move for the country.

Keywords

Ireland, debt crisis, bank failure, European Union

Across the board the 2008 Financial Crisis was rooted in the United States' sub-prime mortgage fiasco, but each country, and region of the world, was affected differently depending on its own financial conditions. Some countries (like Germany) used the excess of credit to continue to invest in American banks and mortgages, white others (like Greece) used the easy access to credit to hide their lack of tax revenue despite their enormous public sector. Ireland however, mimicked the United States (US). Ireland grew its construction and property sector. Irish property developers received loans to develop more and more Irish land while Irish people received easy mortgages to buy homes and condos. Unfortunately, there were not enough people to buy all the homes that the property developers built and as those loans collapsed, unemployment rose drastically and as unemployment rose people drastically people are unable to make their mortgage payments and those loans become nonperforming as well.

As Irish banks were the main holders of the property loans and mortgages their balance sheets turned from high performing in the long term to full of losses both short and long term. Each country needed to develop its own recovery plan because of the unique characteristics of each country's banking landscape, financial sector and government. Ireland benefitted from the banks being the root of their crisis being banking errors, it set them up for an easier recovery than a number of other countries.

IMF Managing Director Christine Lagarde explains Ireland's successful recovery from the crisis through "clarity of purpose, financial and fiscal focus, ownership by the Irish authorities and resilience to stay the course" (Coakley, 2015 p.2). Ireland's successful recovery cannot be denied at this point, they had 5% growth in 2014. Growth was lead by strong exports, from recovered businesses starting production again; and investment, from recovered trust in the banks and financial system (Coakley, 2015). However, she disregards that Ireland used this time to rebuild their banking and financial sector to safeguard small to medium sized enterprises (SMEs) and homeowners.

Ireland's immediate response to the collapse of their banking and financial sector was a complete guarantee of their banks. One of Ireland's next actions was to create the Nation Asset Management Agency (NAMA). NAMA's purpose was to "purchase the large property loans at 'long-term economic value', thereby crystallizing prospective losses" (Honohan, 2012 p.3). This meant that NAMA ate some of the bad loans (loans above €20 million) on an Irish banks balance sheet- banks were able to sell nonperforming loans, at a discount, to NAMA. Selling the nonperforming loans meant that a loss appeared on the banks balance sheet immediately rather than waiting for the loan holder to default and forcing banks to go through the messy arrears or foreclosure process.

Banks took advantage of this opportunity in droves; banks transferred (sold) €74 billion worth of loans at a discount of 57%. Banks were able to remove nonperforming loans from their balance sheets and still receive 43% of the value of the loan, instead of potentially 0% had they kept the loan on their books. This protected the banks from any further deterioration of the Irish property market. A sure 43% of a nonperforming loan guaranteed at least partial repayment. The banks avoided further exposure; if property values continued to fall the banking system would not be subject to those losses (Schoenmaker, 2015).

The benefit of NAMA is that it removes uncertainty on repayment and allowed banks to fully recognize losses earlier than they would without it (Schoenmaker, 2015).

Uncertainty is the bane of financial institutions existence. This differs from risk because with uncertainty the outcome is unknown. Risk refers to the known probability of a negative outcome rather than a positive outcome; risk is how banks make money. Uncertainty however, refers to the unknown probability of a negative outcome. Risk can be planned and compensated for, risky assets have higher rates of return. Uncertainty however eliminates activity in financial markets; credit will be impossible to receive. No one wants to interact with an institution full of uncertainty.

Allowing banks to fully recognize losses meant that banks could have a more realistic idea of how much capital they would need to weather the storm. As every institution worldwide was suffering from liquidity issues, having a realistic idea of how much excess liquidity a bank would need to keep it open makes regulatory institutions happy and more likely to grant liquidity for a bank. It also protects a bank from facing further losses as described above. NAMA's ability to remove uncertainty and allow banks to solidify losses early on was instrumental to Ireland's success.

NAMA also had some freedom to dispose of its assets according to the market. NAMA was provided overall targets to act within but it was not beholden to time requirements for reselling its assets to gain back some value. This was a successful approach because it allowed flexibility, for example because London's market recovered first NAMA was able to dispose of those assets first while waiting for Ireland's market to recover and then dispose of those assets later (Schoenmaker, 2015). The flexibility afforded to NAMA added to the success of NAMA as an asset management agency. NAMA's ability to eat bad loans at a discount was crucial to Ireland's banking system's recovery; eliminating uncertainty and fully realizing losses at an early stage was vital. All things considered, NAMA is an example of a successful bad asset management agency and was crucial, especially in conjunction to the restructuring of Irish banks made possible by the restructuring of Irish banks, to Ireland's ability to recover (Schoenmaker, 2015).

Ireland's blanket guarantee of banks' liabilities was in response to a fear of contagion (Eichengreen, 2015). Watching Lehman Brothers fall in America and the havoc it caused worldwide made all governments concerned about the fallout of not providing their financial institutions necessary capital. Lehman Brothers had worldwide consequences and it was unclear what other banks would have similar effects. Additionally, receiving such a high level of Emergency Liquidity Assistance (ELA) would put a dent in Irish confidence (Eichengreen, 2015). ELA is an immediate payout that would put Ireland's ability to pay into question. Typically a country providing ELA can simply print the money necessary to provide their banks with the required excess liquidity. While it can create inflationary pressures, the collapse of a major bank is usually seen as more dangerous. However, because EU countries are not in control of printing of currency, ELA is more onerous to provide. Ireland cannot simply print money to handle the sudden demand that ELA would present. ELA in the EU is also a very bureaucratic process; it requires unanimous approval from the Board of Governors. ELA also does not allow Ireland to set specific guidelines in the way that a guarantee, backed by solely the Irish government, does. While a guarantee is a long-term payment scheme, it allows Ireland to restructure banks as necessary. It also provides a lot of confidence for the banking sector.

While ELA should provide the same amount of confidence in the banks and banking sector that a government guarantee does, the rise of systemically important banks has shifted ELA to actually remove confidence in a bank. ELA has been increasingly viewed as a lifeline for insolvent banks, instead of its intent as a stopgap for illiquid banks. This trend worked in favor for Ireland, because a guarantee of its debts showed the Irish people, and the markets, that the government of Ireland was willing to stand behind its banking sector rather than asking the EU for help. Because guaranteeing bank debts didn't explicitly involve ECB funds, it did not require an EU vote. Bypassing the EU bureaucracy saved time, effort and political capital. The guarantee and subsequent recapitalization had the added bonus of keeping Irish banks open to receiving ELA in the future if they needed to.

Ireland provided a total of €79.8 billion in recapitalization (€64 billion from the government, €15.5 billion from exchanges on subordinated debt and private equity) to the following Irish banks: Bank of Ireland (BOI), Allied Irish Banks (AIB), Anglo Irish Bank (Anglo), Anglo Irish Nationwide Banking Society (INBS), Educational Building Society (EBS) and Irish Life and Permanent (ILP) (Schoenmaker, 2015). Recapitalization, on its face, was provided through the Irish Government; while the European Financial Stability Facility did provide the funds, they were given to the Irish Government for dispersal (Schoenmaker 11). The dollar amount of recapitalization is high, no doubt, but it provided the Irish government with a lot of leverage to restructure the banks and banking sector as it saw fit.

Through nationalization, mergers and restructuring Ireland created a two-pillar banking system, with two broad banks (BOI and AIB) with €80 to 90 billion in loans and a smaller bank (permanent TSB) with only €30 billion in total loans (Schoenmaker, 2015). They accomplished this through to following rearrangements: nationalizing Anglo in January 2009 and INBS in August 2010 (Schoenmaker, 2015). Anglo deposits were moved to AIB, INBS deposits moved to ILP and Anglo and INBS were then merged into Irish Bank Resolution Corporation (IBRC) (Schoenmaker, 2015). ILP was split, the insurance aspect (Irish Life) was sold on by the government and the banking aspect received state aid and was renamed permanent TSB (PTSB). EBS received state aid and underwent a massive restructuring. Upon completion it was merged into AIB (Schoenmaker, 2015). In sum, AIB absorbed a number of smaller banks (Anglo and EBS), BOI received massive state aid, IBRC was merged/created and PTSB was created. IBRC was never really able to get a handle on its finances and was liquidated in 2013. So effectively, you move from six banks into a concentrated system with two big banks (AIB and BOI) and one small bank (PTSB) (Schoenmaker, 2015).

The benefits to creating such a small banking system may not last forever, but with so much happening in the European system having a consolidated system can make communication and regulation much easier. It does suffer from a lack of competition, that may drive up the prices of loans and other services but Ireland built in safeguards to ensure the two major banks could not shut the Irish government out of its business. The Irish Government will have 75% of the voting rights of AIB and 25% of the voting rights for appointments of the directors or directors on the board for AIB and BOI ("Bank Recapitalisation Plan", 2008).

The nationalizations and mergers leading to the Irish two-pillar system also creates a moral hazard question. Blanket guarantees are the kindle to a moral hazard fire, moral hazard is created when there are no consequences and a blanket guarantee eliminates consequences. On its face then, it is unclear why Ireland would take the chance of encouraging moral hazard but it was unavoidable in this instance. As stated earlier, the guarantee was in response to a fear of contagion throughout the banking and financial system and that was seen as more important than discouraging moral hazard.

In the end Ireland used two stages to manage the crisis- first public policies to stabilize the banks, second restructuring loans held by firms and households (Schoenmaker, 2015). The recapitalizations, restructuring and mergers completed stage one and with the leverage created through recapitalization, the Irish government was able to include a number of policies in restructuring that helps firms and households. Additionally, Ireland appears to have avoided the worst aspects of moral hazard; primarily through two steps—attaching many strings to the bailout and lots of government oversight.

Recapitalized banks were required to provide an additional 10% capacity for lending to small to medium sized enterprises (SMEs) and an additional 30% capacity for lending to first time homebuyers at competitive rates in 2009 ("Bank Recapitalisation Plan", 2008). This is important because 99.8% of all enterprises in Ireland are SMEs and 70% of private sector employment is provided by SMEs (McDonald & Tyrrell, 2013). Providing an additional 10% lending capacity for SMEs opens an enormous amount of credit to the aspect of the economy that will provide the largest opportunity for economic recovery. SMEs are the backbone of all economic recovery, especially in Ireland where so much of the economy is composed of them. In financial panics and banking crisis, credit for expansion of a business is nearly impossible to come by. If banks are concerned about their ability to cover their liabilities and nonperforming loans are the root of the problem, a bank is unlikely to be encouraged to continue lending at all much less increase lending capabilities. The Irish government had an eye on economic recovery and not just weathering the storm.

On that same note, requiring an additional 30% capacity for new homebuyers encourages economic growth. First time homebuyers are typically people with a high need to spend and a healthy income. First time homebuyers feature a lot of people in their late 20s, early 30s with steady jobs; they are the bread and butter of the economy. Again, mortgages were a major cause of the banking crisis but instead of allowing Irish banks to cut down their mortgage business, the government is requiring them to expand. The government is focused on improving the daily life of the Irish people, instead of what the bankers want, and that allows them to push for growth.

This is not to say that SMEs did not feel the effects of a near financial collapse, because SMEs make up such a large portion of Ireland's economy there is no way that SMEs didn't also suffer major losses or have been saddled with large amounts of debt. To this end the Irish government proposed "Examinership Lite" in late 2012 to make it easier for SMEs to restructure their debts (McDonald &Tyrrell, 2013). Ireland went into the banks and restructured their debt from above; allowing legislation for SMEs to restructure their debts only makes sense. Additionally, NAMA's restrictions to only large commercial loans have burdened many SMEs with their inability to restructure a number of their loans. Passing "examinership lite" would afford SMEs the same treatment afforded to large banks.

The Department of Finance also created the Strategic Banking Corporation of Ireland to lend to SMEs via banks on longer and more favorable terms than currently available (Schoenmaker, 2015). It has €800 million to lend. This is another way Ireland is ensuring that SMEs would have funding to continue growing the economy. There were a few other government entities created to encourage growth and development. The National Pension Reserve Fund is being re-oriented from a long-term pension fund to a domestically focused investment fund, Ireland Strategic Investment Fund (ISIF), to support economic activity and employment. It begins with valuations of €6.8 billion (Schoenmaker, 2015).

The Irish government also included protections for the Irish people, including requiring banks to wait at least six months from first arrears to the enforcement of any legal action on repossession of a person's primary residence ("Bank Recapitalisation Plan", 2008). This allows a grace period for Irish homeowners instead of an immediate repossession. This is not a necessary provision, in fact it could be argued that it makes a banks ability to recover losses more difficult, but this speaks to who the Irish government was concerned with while they were restructuring the banks and creating policies in response to the crisis. The Irish government was concerned with the Irish people and homeowners and went out of their way to provide some bits of protection.

The Irish government then required banks to commit themselves to a number of items that don't inherently matter to Irish bankers but may be very important to the Irish people. They are committed to "broaden the provision of basic or introductory bank accounts and will promote these accounts to socio-economic groups where the holding of bank accounts is less prevalent and to those who find that a current account does not suit their basic banking needs" ("Bank Recapitalisation Plan", 2008 p.5). This is a commitment to serving the non-banking or under banked populations. This may seem in the clear interests of the bankers because it would increase their customer base, but for people who are under banked or nonbanking having banks restructure basic accounts to serve their needs is invaluable. In addition, banks will provide funding "to support and develop financial education for consumers and potential consumers" ("Bank Recapitalisation Plan", 2008 p.5). They also enacted personal insolvency reforms in late 2012, including a shortening of the discharge period for bankruptcy from 12 years to 3 years (Schoenmaker, 2015).

Banks will also introduce a €100 million fund to support environment friendly investments with an aim to reduce energy usage, switch to renewable energies and reduce Ireland's carbon footprint ("Bank Recapitalisation Plan", 2008). This is clearly positive for the environment, banks are now creating a large incentive for developments in environmental technology but this is also a growth sector for the economy and therefore will be beneficial to the banks as well. Environmental technology is a growth sector that is typically lacking in funding so forcing banks to invest in it will decrease the likelihood that the industry will suffer from lack of funding in the future.

To avoid a crisis like this one happening again the Central Bank of Ireland (CBoI) proposed more stringent lending requirements to both domestic banks and foreign-owned banks operating in Ireland (Schoenmaker, 2015). CBoI proposed to restrict lending for primary dwelling purchase above 80 per cent loan to value (LTV) to 15 percent of aggregate value of the flow of all housing loans for primary domestic house (PDH) purposes; a lower threshold is proposed for bought to loan (BTL) mortgages- limit BTL loans above 70 percent LTV to 10 percent of all BTL loans (Schoenmaker, 2015). These requirements would decrease the possibility of one sector of loans, property and mortgage loans, from destroying the banking sector again. By limiting the proportion on banks' balance sheets, they will limit the potential exposure these banks will face in the future; again this is the Irish Government setting itself up for success.

Ireland's success, while impressive, does not provide a universal map for recovery. The largest recommendation and implication for others is that the first step in crafting Ireland's, or any response, must be discovering the underlying cause of the crisis and letting that dictate the response. As the banks were the root cause of Ireland's crisis, the response needed to focus on the banks. This will not always be the case in future crises and if other countries hope to have the same success that Ireland has, they will also need to understand the root cause.

The other major implications from this crisis are that bad asset management agencies (like NAMA) are essential to a speedy recovery, everyday citizens must be catered to and, that regulation is critical. NAMA-esqe agencies allow banks to realize losses sooner and prepare banks' books for the future. Average citizens are the main generators of economic recovery; they must feel safe spending their money again. Banks receiving bailouts eliminates a consequence of their bad behavior; the banks and bankers are no longer facing bank failure and loss of funds for essentially gambling away money. The perverse incentives, without outside interference, should drive up the moral hazard problem. The outside interference necessary is increased regulation. By attaching strings to the bailout funds provided to the banks, the government and its regulatory agencies can attempt to minimize the impact that the next financial crisis will have on banks and everyday citizens.

Ireland's crisis was born from the banking sector; the Irish banks set themselves up for failure and dragged the government and the Irish people along with them. Therefore, the Irish Government focused all their energy on not allowing another crisis like this one to happen again. They restructured their banking and financial sector and focused on how the restructuring would affect SMEs and families. This focus on the main drivers of the economy, in addition to the unique structure of Ireland's crisis, is why Ireland has been able to recover much faster/better than the other periphery countries. At the end of the day, Ireland's issue was not a fiscal issue and it's much easier to change banking regulations than tax policy and culture.

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